

# Investment Consultants Market Investigation

## Working paper on the supply of fiduciary management services by investment consultancy firms

**29 March 2018**

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the issues statement published on 21 September 2017 and other working papers published.

These papers do not form the inquiry group's provisional decision report. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional decision report, which is currently scheduled for publication in July 2018, taking into consideration (among other matters) the evidence obtained, responses to the consultation on the issues statement and responses to the working papers as well as other submissions made to us.

Parties wishing to comment on this paper should send their comments to [investmentconsultants@cma.gsi.gov.uk](mailto:investmentconsultants@cma.gsi.gov.uk) by 12 April 2018.

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The Competition and Markets Authority has excluded from this published version of the working paper information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. [Some numbers have been replaced by a range. These are shown in square brackets.] [Non-sensitive wording is also indicated in square brackets.]

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## Summary

1. This working paper sets out our initial analysis of competition issues that may arise when firms offer both investment consultancy (IC) and fiduciary management (FM) services.
2. In particular, this paper considers the theory that customers that receive IC services are steered towards investment consultants' in-house FM services, when an alternative solution or deal could have been in their best interests.
3. The paper also sets out and seeks views on potential remedies to any issues that we may identify.
4. The FM services sector is growing fast; the value of UK pension scheme assets invested through FM arrangements was over ten times greater in 2017 compared to a decade earlier.<sup>1</sup> The evidence we have reviewed indicates that selling FM services to existing IC clients is an important part of many integrated firms' (IC-FM firms) strategies to grow their businesses.
5. It appears from the CMA survey<sup>2</sup> and other sources that firms have had some success with these strategies, with around half of pension schemes buying FM choosing to appoint an IC-FM firm that was already acting as their IC.<sup>3</sup> Of the FM mandates won by the three largest IC-FM providers, the firm was already supplying IC services to the client in the majority of cases (71%). Therefore it would appear that any competition issues in this area potentially impact a large part of the sector.
6. We have heard that FM services may bring benefits for pension schemes. In addition, some stakeholders said that when an IC provider also offers FM services, this may bring further synergies and benefits. However, we found wide agreement that this arrangement also leads to potential conflicts between the interests of IC-FM firms and those of the clients that they advise, which need to be managed effectively. It is not clear whether existing FCA regulation fully addresses these potential conflicts of interest (for example, some IC services do not fall within the scope of the FCA's regulatory perimeter).

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<sup>1</sup> Based on KPMG's 2017 UK Fiduciary Management Survey (the KPMG survey).

<sup>2</sup> The CMA's survey of pension scheme trustees was conducted by IFF Research (the CMA survey). In total we surveyed 966 trustees, each on behalf of the trustee board for a trust-based pension scheme with 12+ members (across DB, DC and hybrid schemes). IFF's report of the survey findings has been published separately on our website. We have undertaken our own analysis using the survey dataset and therefore some of the statistics in this working paper are different from those presented in IFF's report.

<sup>3</sup> Based on the CMA survey, 47% of schemes buying FM first bought these services from their existing IC. Based on client-data collected by the CMA from parties, 55% of mandates were awarded to firms that were already acting as IC to the customer.

7. We heard from a range of stakeholders that where customers tender and/or get advice from third-parties before buying FM, this can help support competition and mitigate potential conflicts of interest. In the CMA survey, around a third of trustees said they asked a third-party to run a tender process when first entering FM, while half of trustees said they received some form of third-party support (in the form of advice or running a tender). Around a quarter of trustees said they ran a tender or invited proposals without external help.
8. The IC-FM firms in our sample have policies and processes in place to help them manage conflicts of interest that may arise in their businesses. A step that many IC-FM firms take is that they will not act as a third-party evaluator (TPE) and will not compare their own FM service to those of rival FM providers.
9. We have also considered evidence and views on how IC-FM firms handle these issues in practice.
10. Based on the CMA survey, 30% of trustees think that investment consultants steering clients into their own FM services is a problem that is generally well managed, whereas a further 30% think it is a problem and more should be done to address it.
11. Based on internal and client documents produced by firms and other evidence reviewed to date, we have seen some examples of IC-FM firms:
  - (a) having strong and persistent strategies to sell FM to existing IC clients;
  - (b) mentioning their own FM service to IC clients, but not mentioning other FM providers;
  - (c) producing documents that compare their own FM service to alternative (non-FM) products or services;
  - (d) producing documents that provide advice on FM and do not mention conflicts of interest, or only mention conflicts of interest in a general sense.
12. We recognise that it is not straightforward to say how the practices above might impact competition. However, depending on the context, these practices could contribute to some customers being steered towards the FM services of their incumbent IC without having fully considered the alternatives.
13. Overall, it is clear that the demand for FM services has grown strongly in recent years and that a significant proportion of FM customers have bought

these services from their existing IC. We have seen some evidence of practices and behaviours that could be consistent with some customers being steered towards the FM services of their incumbent IC, without having applied much competitive pressure on the incumbent firm.

14. We have further work planned that will help us to assess this theory of harm, including our planned working papers on trustee engagement and gains from engagement.<sup>4</sup>
15. We welcome further evidence and views on this theory of harm and on the evidence, emerging findings and potential remedies set out in this document.

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<sup>4</sup> We set out our plan for working papers in our [progress update](#) of 21 February 2018.

## Introduction

16. This working paper sets out our initial analysis of the competition issues that may arise when businesses offer both investment consultancy and fiduciary management services.
17. The paper in turn sets out:
  - The conceptual framework – outlining the theory of harm we are investigating and the conceptual framework that we have developed (paragraph 18 to 28).
  - Background – describing aspects of the sector relevant to the discussion of potential conflicts (paragraph 29 to 46)
  - Demand side assessment – our initial analysis of evidence in relation to trustees as purchasers of FM services (paragraph 62 to 73).
  - Supply side assessment – our initial analysis of evidence on the incentives and behaviour of firms in relation to FM (paragraph 74 to 121).
  - Potential remedies – outlining our current thinking on potential remedies if we were to find an adverse effect on competition (AEC) (paragraph 125 to 132).

## Conceptual framework

18. Our Issues Statement noted that investment consultants may have several conflicts of interest. As a result, their objectives may not be fully aligned with those of the clients they advise, in turn compromising the value for money of their advice and quality of the services that they provide.
19. This working paper only considers issues relating to investment consultants selling their in-house FM services to their existing IC clients. We are continuing to examine other potential conflicts of interest as outlined in our Issues Statement and expect to cover these in our provisional findings report.

### Theory of harm addressed in this paper

20. In summary, the theory of harm addressed in this paper is that: **when investment consultancy firms act as advisors to their customers and also offer FM services, customers are steered towards consultants' in-house FM services, when an alternative solution or deal could have been in their best interests.**
21. We consider that plausible variants of this theory of harm include one or more of the following:

- (a) In their role as advisors, investment consultants provide general advice on fiduciary management that over emphasises the benefits relative to the costs;
- (b) In their role as advisors, investment consultants mention their own fiduciary management service, while not mentioning other providers or the possibility of a tender process;
- (c) In their role as advisors, investment consultants mention their own fiduciary management service, while not mentioning the conflicts of interest associated with cross-selling;
- (d) In their role as advisors, investment consultants advise customers on which fiduciary (or non-fiduciary) provider or service should be selected, and present their own service favourably;
- (e) When marketing or promoting their own fiduciary management service, the incumbent firm over emphasises the benefits relative to the costs, or provides unclear information on benefits or costs;
- (f) At some points in the customer journey, it is not made clear to customers whether the incumbent firm is acting as an impartial advisor, or whether it is marketing or promoting its own service, and
- (g) Customers have behavioural biases in favour of their incumbent provider of investment consultancy services, so that they do not shop around or negotiate as hard when it comes to considering the fiduciary management offer of the incumbent provider.

22. Under the theory of harm, one or more of the features above mean that:

- (a) Customers buy fiduciary management services to an extent that is not in their best interests; or
- (b) Customers buy fiduciary management services from their incumbent advisor, when they could have got a better deal (in terms of price or quality) from another provider; or
- (c) Customers buy fiduciary management services from their incumbent advisor on less favourable terms, compared to if they hadn't had an existing consultancy relationship with that provider.
- (d) IC-FM providers build a strong incumbency advantage when selling FM, making it more difficult for non-integrated FM providers to gain customers and scale, and thereby reducing the competitive constraint these providers exert on IC-FM providers.



23. We note that some of the features above are more closely associated with conflicts between the interests of firms and their clients. For example, features where investment consultants potentially provide advice on FM in a way that prioritises their own interests above the interests of their consultancy clients.
24. Other features above may be more closely associated with a general incumbency advantage for some investment consultants. For example, features where customers potentially do not shop around when considering the FM proposals of their incumbent investment consultant.
25. Nonetheless, we believe that the features above are related and that there is merit in considering them together at this stage.

### **Analytical framework**

26. Table 1 shows the framework we have developed in order to assess the theory of harm:

**Table 1 Analytical framework for assessing the theory of harm**

<b>Area for assessment</b>	<b>Rationale</b>	<b>Example evidence sources</b>
<p><b>1. Demand side assessment</b> including customer characteristics and buying patterns</p>	<ul style="list-style-type: none"> <li>• The extent to which customers are active and engaged will have a bearing on how they interpret and act upon the advice and information that they receive from IC-FM firms.<sup>5</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Evidence from the CMA survey.<sup>6</sup></li> <li>• Evidence from other surveys and reports.</li> <li>• Firms' submissions.</li> </ul>

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<sup>5</sup> This relates to the 'Assess' and 'Act' elements of our Access, Assess, Act framework, as set out in our [guidelines for market investigations](#).

<sup>6</sup> Our trustee survey, conducted by IFF Research ('CMA survey'). In total we surveyed 966 trustees, each on behalf of the trustee board for a trust-based pension scheme with 12+ members (across DB, DC and hybrid schemes). Those surveyed may have bought advisory and/or FM services, or may not have bought either. We present relevant results from the survey within each section below. IFF's report of the survey findings has been published on our website.

Area for assessment	Rationale	Example evidence sources
<p><b>2. Supply side assessment</b> including IC-FM firms' incentives and conduct</p>	<ul style="list-style-type: none"> <li>We would only expect firms to seek to steer existing clients towards their FM solutions if they saw this as a profitable strategy.</li> <li>The behaviours of IC-FM firms, including the advice and information that they provide, may have a bearing on customers that are considering buying FM.<sup>7</sup></li> </ul>	<ul style="list-style-type: none"> <li>Evidence from the CMA survey.</li> <li>Financial information indicating the profitability of IC and FM services.</li> <li>Firms' conflict management policies and processes.</li> <li>Industry guidance and rules regarding conflict management.</li> <li>Documents supplied by firms to trustees.</li> <li>Firms' internal strategy documents.</li> </ul>
<p><b>3. Outcomes for customers</b></p>	<ul style="list-style-type: none"> <li>To assess whether firms selling FM to existing advisory clients is likely to have led to good or bad market outcomes for customers.</li> </ul>	<ul style="list-style-type: none"> <li>Evidence from the CMA survey.</li> <li>Analysis of fees charged to IC and FM clients.</li> <li>Evidence on other costs and benefits of FM.</li> <li>Analysis of FM switching.</li> </ul>
<p><b>4. Market outcomes</b></p>	<ul style="list-style-type: none"> <li>IC-FM firms gaining market share at the expense of non-integrated FM firms could indicate the existence of incumbency advantages for these firms.</li> </ul>	<ul style="list-style-type: none"> <li>Analysis of market structure and barriers to expansion for FM providers that do not offer IC services</li> </ul>

Source: CMA Analysis

<sup>7</sup> This relates to the 'Access' element of our Access, Assess, Act framework.

27. This working paper sets out the work that we have done to date, which relates to the first two assessments in Table 1.
28. In this working paper, we refer to a range of documents submitted to us by parties, including documents that they produced during the last five years. We recognise that some firms have updated their policies and practices during this period. We consider that it is relevant to refer to a range of documents, including those which pre-date recent updates that firms may have made to their policies and practices.<sup>8</sup> As we consult on our analysis and emerging thinking, no assumption should be made as to the weight to be placed on such documents.

## **Background**

29. This section provides a brief introduction to the services that are relevant to this paper and to the supply and demand side for these services.

### **Overview of investment consultancy and fiduciary management services**

30. IC services can include a range of advice designed to help customers set and meet their investment objectives. Based on the CMA survey, strategic asset allocation and manager selection are the IC services most commonly purchased by trustee boards buying these services.<sup>9</sup> IC services can also include advice in relation to FM.
31. FM services are where a provider makes and implements investment decisions for customers based on their investment strategy. Based on the CMA survey, reporting and operational services, strategic asset allocation and manager selection are the activities that are most commonly delegated by pension scheme trustees to fiduciary managers.<sup>10</sup> The scope of FM arrangements vary. In this working paper, we define full FM mandates as those where responsibility is delegated to a provider for all of a customer's assets. We define partial FM mandates as arrangements where responsibility is delegated for some assets only.
32. Based on the CMA survey, 13% of UK pension schemes currently buy FM services.<sup>11</sup> There has been sustained growth in the use of FM by these

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<sup>8</sup> Such documents may show evolution of practices, provide background context for client relationships formed at the relevant time and which may be continuing to date, or simply provide examples of a type of practice on which we may wish to comment more generally as this investigation progresses.

<sup>9</sup> Based on all responses to the CMA survey.

<sup>10</sup> Based on all responses to the CMA survey.

<sup>11</sup> The numerator of this statistic takes into account responses where the pension scheme was buying FM from a confirmed provider of FM services. Our list of confirmed providers of FM services includes 18 firms; a total of 145.

customers in recent years. KPMG's survey indicates that there were 61 FM mandates (£12bn of assets under management) in 2007 and 805 FM mandates (£135bn of assets under management) by 2017.<sup>12</sup> Therefore the number of FM mandates and the value of assets invested through FM were over ten times higher in 2017 compared to a decade earlier.

### Overview of suppliers

33. The supply side for IC and FM services in the UK includes firms with a variety of business models.
34. Some firms offer either investment consultancy or fiduciary management services; we refer to these as 'non-integrated IC firms' and 'non-integrated FM firms' respectively. Other firms offer both services; we refer to these as 'IC-FM firms'. Some firms also offer other services, such as actuarial or asset management services.
35. IC-FM firms supplying institutional investors in the UK include the seven firms listed in Table 2 below.<sup>13</sup>

**Table 2 Firms providing investment consultancy and fiduciary management services**

*IC-FM firms*

1. Aon
2. Cambridge Associates
3. JLT
4. Mercer
5. River & Mercantile
6. Russell Investments
7. Willis Towers Watson (WTW)

Source: CMA Analysis

Note: Firms listed alphabetically

36. The three largest of these firms by combined IC and FM revenue are Aon, Mercer and WTW.<sup>14</sup> We have collected client-level data on 700 FM mandates.<sup>15</sup> Of these, just over half are held by the three largest IC-FM firms.
37. As demand for FM services has grown, these three firms have grown their share of the FM sector; over the last five years their combined share of the

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respondents bought FM from one or these firms whereas 134 respondents said they bought FM from a firm that we were not able to confirm as a provider of FM services.

<sup>12</sup> KPMG's 2017 UK Fiduciary Management Survey.

<sup>13</sup> These are the seven largest IC-FM firms, based on combined UK revenue for IC and FM services in the last year, using information supplied by these parties.

<sup>14</sup> Based on combined UK revenue for IC and FM services in the last year, using information supplied by these parties.

<sup>15</sup> We requested client-level information from FM providers and obtained a sample of 700 FM mandates. This compares to a total of 805 mandates in the UK in 2017, according to the KPMG 2017 FM survey.

FM sector grew by around [10 – 20] percentage points to reach around 50% of the FM sector by revenue.

38. Over the same period, these three IC-FM firms saw their combined share of the IC sector fall by around [10 – 20] percentage points to around 50% of the IC sector by revenue.
39. In parts of this working paper we have focused in more detail on larger IC-FM providers.

### Overview of legal and regulatory framework

40. We have considered whether potential conflicts, for example, between the best interests of IC-FM firms and the best interests of their clients are covered by the current regulation of those firms.
41. The subject of conflicts of interest is expressly covered by FCA rules and regulations that apply to firms which it regulates. Regulated firms are primarily those which have FCA permission to carry on one or more regulated activities.<sup>16</sup>
42. Regulation applies to some, but not all, of the activities carried out by IC-FM firms. Whereas it covers the principal activities which are undertaken in the course of providing FM services, it covers only partially the activities undertaken in the course of providing IC services. By way of example:
  - (a) In respect of IC services, the regulated activity of ‘advising on investments’ covers personal recommendations made by an investment consultant in respect of certain investments.<sup>17</sup> For most FCA-authorized firms, strategic advice (such as advice on strategic asset allocation) that does not constitute a personal recommendation will not in itself be a regulated activity, but it could still be covered by FCA regulation if, for example, it forms an integral part of another regulated activity.<sup>18</sup> Similarly,

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<sup>16</sup> Regulated activities are set out in the [Financial Services and Markets Act 2000 \(Regulated Activities\) Order 2001](#), SI 2001/516, as amended (the RAO).

<sup>17</sup> With effect from 3 January 2018, for the bulk of firms which hold a FCA permission other than (or in addition to) ‘advising on investments’ or ‘agreeing to carry on the regulated activity of advising on investments’, the regulated activity of ‘advising on investments’ applies only to the extent that they provide a ‘personal recommendation’ (that is the effect of Article 53(1A) – (1D) [RAO](#)). For these purposes, a ‘personal recommendation’ is, in summary: (a) a recommendation that is made to a person in their capacity as an investor or potential investor (or an agent of either), (b) it is a recommendation (among other matters) to buy, sell, subscribe for, hold or underwrite a particular financial instrument, (c) it is presented as suitable for that person or is based on a consideration of the circumstances of that person, and (d) it is not issued exclusively to the public (Article 53(1C) and (1D) [RAO](#); see also Article 9 of [Delegated Regulation \(EU\) 2017/565](#)).

<sup>18</sup> See, for example, the FCA’s [Perimeter Guidance Manual](#) (PERG) 13.3 Investment Services and Activities, Q21.

the regulated activity of ‘advising on investments’ does not cover advice on the suitability of an FM service, in so far as the FM service in question does not in itself constitute a specified investment to which that regulated activity applies.

(b) In respect of FM services, the regulated activity of ‘managing investments’ covers the exercise of discretion in managing the assets belonging to another person.<sup>19</sup>

43. We welcome views on whether the perimeter of existing regulation is sufficiently broad to cover the potential conflicts of interest faced by IC-FM firms.

44. Further detail on the key relevant provisions is set out in [Annex A](#).

### Overview of customers

45. Institutional investors that use IC and FM services include pension schemes, charities, insurance companies, and endowment funds. As set out in our [Progress Update](#), we are currently minded to focus on pension schemes as the main customer group for investment consultants and fiduciary managers.

46. In trust-based pension schemes, a pension trustee is a person or company, acting separately from the employer, who holds assets in the trust for the beneficiaries of the scheme. Trustees are responsible for ensuring that the pension scheme is run properly and that members' benefits are secure. They are legally required to obtain and consider ‘proper advice’ on their investment decisions<sup>20</sup> and this underlies their more frequent use of investment consultants, compared to other types of institutional investor.

## Stakeholder views

### IC-FM firms

47. Most of the IC-FM firms that we heard from acknowledged that firms offering multiple services may have conflicts of interest in their business models. They also stressed that they act in clients’ interests and that offering both IC and FM services results in benefits for clients.

48. In relation to conflicts of interest in general:

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<sup>19</sup> FCA Glossary and Article 37 [RAO](#).

<sup>20</sup> Section 36, [Pensions Act 1995](#).

- (a) All of these firms said that they have systems and policies in place to help them manage potential conflicts;
  - (b) Several said that they are incentivised to manage conflicts effectively, since any failure to do so would damage their reputation and harm their competitive position;
  - (c) River & Mercantile (R&M) said that, as an FCA regulated firm, it is under an obligation to avoid and manage any potential conflicts so as to deliver an outcome in which there is no detriment to clients.<sup>21</sup>
49. In relation to selling FM to existing consultancy clients, some firms indicated that part of their conflict management strategy is to avoid providing certain types of advice. For example:
- (a) Aon said that: ‘while we may recommend to a client that they consider FM Services, we will not recommend to a client that they choose our own service, although we will introduce it. If asked by the client to do so, we provide names of third party evaluators who will advise on suitable competitor fiduciary management services’.<sup>22</sup>
  - (b) Mercer said that: ‘where we introduce fiduciary management...to an existing client - we will not advise on or compare competing solutions’ and that ‘we do not act as a ringmaster in the investment advisory and fiduciary management markets in order to avoid conflicts between this role and our role as a potential service provider’.<sup>23</sup>
  - (c) WTW said that: ‘The decision about whether to adopt a FM approach is the client’s and the client will manage this process. When we discuss the implementation options with clients, we do not “advise” that clients move to a fiduciary model’.<sup>24</sup>
  - (d) Cambridge Associates said that it does not recommend its own services and products to its own clients.<sup>25</sup>
50. Several IC-FM firms noted that FM appointments have become more competitive over time, with many clients now using tenders and/or Third-Party Evaluators. However Spence & Partners, a firm that has recently started

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<sup>21</sup> Source: River & Mercantile’s Issues Statement response.

<sup>22</sup> Source: Aon’s Issues Statement response.

<sup>23</sup> Source: Mercer’s Issues Statement response.

<sup>24</sup> Source: WTW’s submissions to the CMA.

<sup>25</sup> Source: the CMA’s hearing with Cambridge Associates.

offering IC and FM services, said that trustees rarely tender when they move from a purely investment consultancy mandate to a fiduciary mandate.<sup>26</sup>

51. JLT said that that they do not see a 'cliff edge' between IC and FM and that the move to FM is usually part of an evolving strategy.<sup>27</sup>
52. Several IC-FMs said that offering both IC and FM within a single firm brings benefits to clients. For example:
  - (a) Mercer, Aon and R&M said that their business models allow clients the flexibility to access their capabilities through a range of solutions.<sup>28</sup>
  - (b) Aon said that there are efficiencies from offering both IC and FM, including the ability to negotiate lower fees with asset managers and the ability to share common costs.<sup>29</sup>
  - (c) R&M highlighted the ability to share best practice across these services.
  - (d) Aon said that the rapid growth seen in FM over recent years had benefitted their firm and their clients alike.<sup>30</sup>
53. IC-FM firms also said that FM services in general offer benefits to clients including more responsive implementation of investment strategies.
54. Many IC-FM firms said that investment consultants who do not offer FM may be subject to an equally serious (or more serious) conflict, in that they may fail to recommend FM to their advisory clients in order to avoid losing advisory work. These firms also raised a range of other conflicts of interest. These other conflicts are not covered in this working paper. We will consider these as part of our wider investigation.

#### **Other stakeholders**

55. Several non-integrated IC firms agreed with the characterisation of the potential conflict of interest as set out in our Issues Statement and said that it should be in scope of the market investigation.
56. For example, Redington said: 'We believe that when a consulting firm offers a fiduciary product, an incentive potentially exists to channel clients into higher revenue generating opportunities (for the firm or individual consultant) even if

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<sup>26</sup> Source: the CMA's hearing with Spence & Partners.

<sup>27</sup> Source: JLT's submissions to the CMA.

<sup>28</sup> Source: Issues Statement responses.

<sup>29</sup> Source: Aon's Issues Statement response.

<sup>30</sup> Source: Aon's submissions to the CMA .



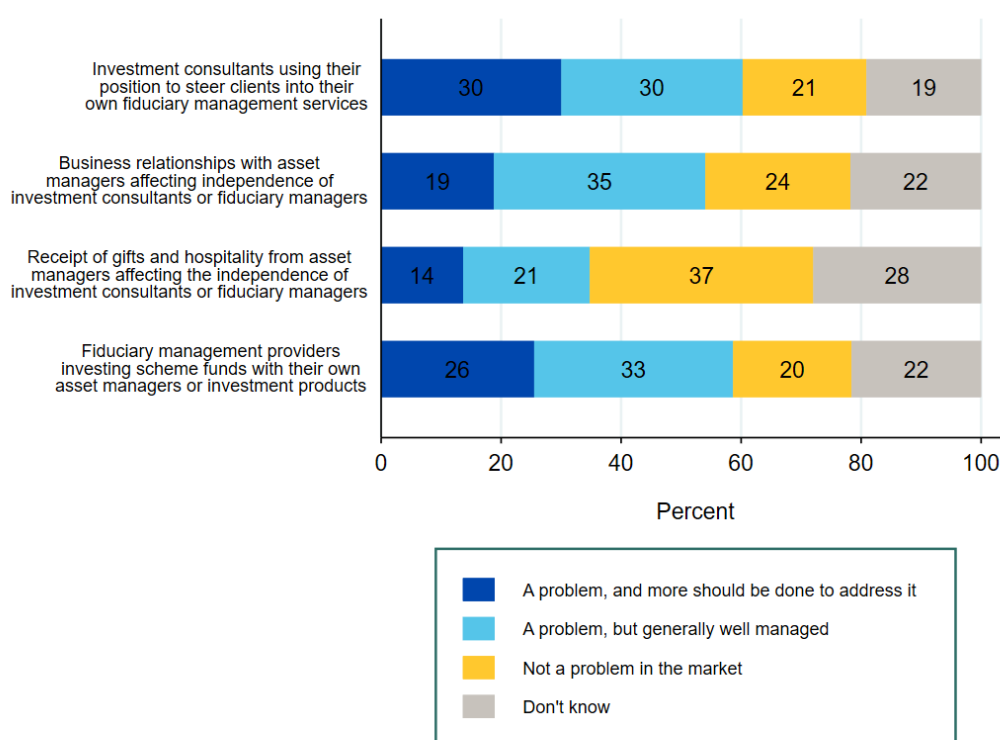
it is suboptimal, not entirely appropriate for the client or does not represent the best achievable value for money from the client's perspective.'<sup>31</sup>

57. Several non-integrated IC firms and other industry stakeholders indicated that, where present, mechanisms such as competitive tenders or oversight by an independent advisor could help mitigate the potential conflict of interest.
58. These stakeholders also raised other potential conflicts of interest; we will consider these as part of our wider investigation.

### Trustees

59. As shown in Figure 1 below, the CMA survey asked trustees for their perception of four potential conflicts of interest.<sup>32</sup> Only the first of these is within the scope of this working paper; the others are presented below only for the sake of comparison.

**Figure 1. Trustee perceptions of conflicts of interest**



All schemes: All (966)

Source: CMA survey, question Q1\_1 'Would you say investment consultants using their position to steer clients into their own fiduciary management services is...?', question Q1\_2 'Would you say business relationships with asset managers affecting the independence of investment consultants or fiduciary managers is...?', question Q1\_3 'Would you say receipt of gifts and hospitality from asset managers affecting the independence of investment consultants is...?', and question Q1\_4 'Would you say fiduciary management providers investing scheme funds with their own asset managers or investment products...?'

<sup>31</sup> Source: Redington's Issues Statement response.

<sup>32</sup> Based on all responses to the CMA survey.

60. The CMA survey found that:
- (a) 60% of trustees perceived that investment consultants steering clients into their own fiduciary management services was a problem;
  - (b) of those trustees that perceived that it was a problem, half said that it was generally well managed (30% of all trustees), whereas the other half said that more should be done to address it (30% of all trustees), and
  - (c) the proportion of trustees saying that more should be done to address the conflict was higher for this conflict (30%) than for any of the other three conflicts that trustees were asked about (19%, 14% and 26% respectively).
61. There were some notable differences in how different trustees perceived investment consultants steering clients into their own fiduciary management services:
- (a) professional trustees were more likely to say that this was a problem and more should be done (62% of professional trustees, compared to 30% of all trustees);
  - (b) trustees of larger schemes were more likely to say that that this was a problem and that more should be done (42% of larger schemes, compared to 32% of medium schemes and 22% of smaller schemes).

## **Demand side assessment**

### **Customers' FM provider selection decisions**

#### *Client data*

62. We collected client-level data from parties covering 700 FM mandates.<sup>33</sup> Of all the FM mandates in our sample:
- (a) the vast majority (88%) were awarded to an IC-FM firm;
  - (b) just over half (53%) were awarded to one of the three largest IC-FM firms, and

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<sup>33</sup> Our sample of 700 mandates compares to a total of 805 mandates in the UK in 2017, according to the KPMG 2017 FM report.

- (c) just over half (55%) were awarded to an IC-FM firm that was already supplying IC services to the client.
63. Of the FM mandates awarded to the three largest IC-FM firms, we found that the firm was already supplying IC services to the client in the majority of cases (71%).

#### *CMA survey*<sup>34</sup>

64. The CMA survey asked trustees about the FM providers that their pension scheme first selected and that they currently used. The survey indicated that:
- (a) when appointing their first FM provider, around half of all schemes buying FM selected their existing IC (47%), and
  - (b) as of the time of the survey, the majority of schemes buying FM also bought IC services from that provider (74%).
65. There are several possible explanations for the differences between the two statistics above. Firstly, some schemes may have appointed a firm that was not previously their IC provider to supply IC and FM services through a single process. Secondly, some schemes may have appointed a firm that was not their IC provider to supply FM services, before subsequently also starting to buy IC services from that firm.
66. Overall, the evidence from the CMA survey and the client data set out in the paragraphs above indicates that a significant proportion of pension schemes buying FM have appointed their existing investment consultant to supply these services.

#### *Other behaviours of customers buying FM*<sup>35</sup>

67. The CMA survey asked about the actions that pension scheme trustees took when first buying FM. The chart below indicates that:
- (a) fewer than half of schemes sought advice from a third-party when buying FM for the first time (44%);<sup>36</sup>

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<sup>34</sup> The CMA survey statistics presented in this section are based on responses where the pension scheme was buying FM from a confirmed provider of FM services.

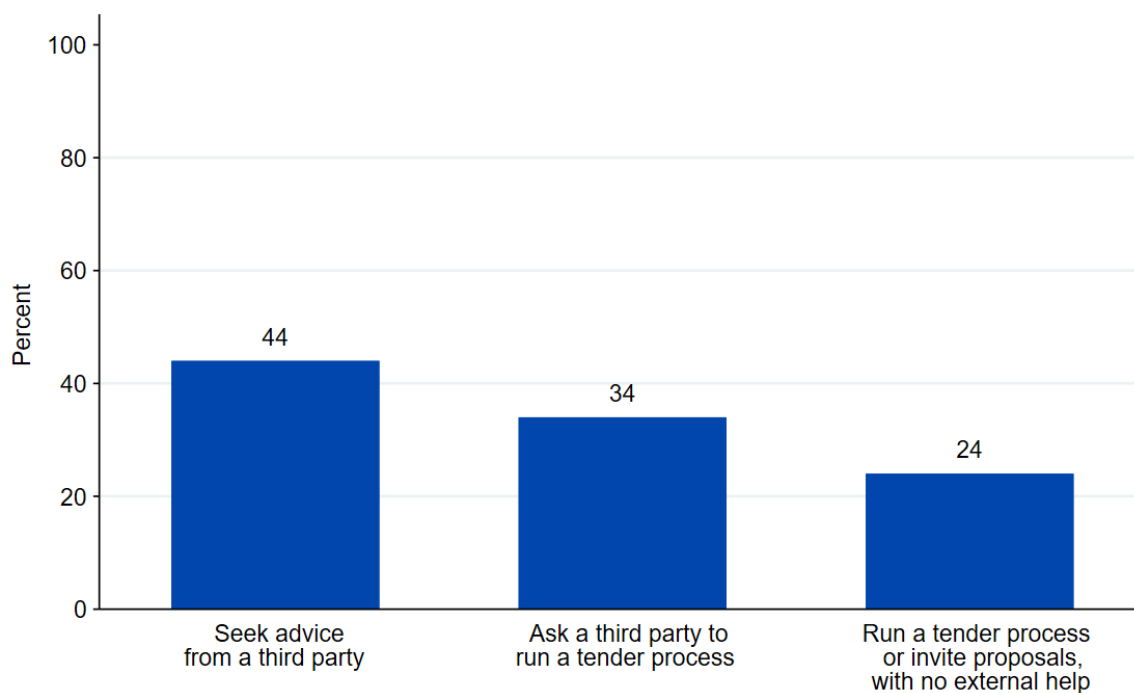
<sup>35</sup> The CMA survey statistics presented in this section are based on responses where the pension scheme was buying FM from a confirmed provider of FM services.

<sup>36</sup> Source: CMA survey, question L5. 'Which of the following, if any, did the board of trustees do when you were buying fiduciary management for the first time?'. Estimation is based on the sample of 145 clients who bought FM from a confirmed FM provider.

(b) around a third of schemes asked a third-party to run a tender when buying FM for the first time (34%);<sup>37</sup>

(c) around a quarter of schemes ran a tender process or invited proposals with no external help, when buying FM for the first time (24%);<sup>38</sup>

**Figure 2. Behaviours of customers when first buying FM**



*Currently buying FM: All (145)*

Source: CMA analysis of CMA survey data, question L5 'Which of the following, if any, did the board of trustees do when you were buying fiduciary management services for the first time?'.<sup>37</sup>

68. Combining the results at (a) and (b) above, 49% of schemes received some form of third-party support (in the form of advice or running a tender) when buying FM services for the first time. However, asking a third-party to run a tender (as 34% of schemes were reported to have done) is likely to represent a stronger form of market testing compared to only seeking third party advice.

69. The survey found that the median number of providers invited to submit a tender or proposal was three; as was the median number of providers who responded to the invitation.<sup>39</sup>

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

<sup>39</sup> Source: CMA survey, questions L6. 'In total, how many providers did you invite to submit a tender or proposal?' and L8: 'How many tenders or proposals did you receive?'. Estimations are based on the sample of

70. KPMG's 2016 and 2017 surveys indicate that the proportion of new FM appointments in a given year that were advised by an independent third-party has grown from 23% in 2015, to 33% in 2016, and 60% in 2017.

### **Summary of emerging findings on the demand side**

71. The evidence we have reviewed indicates that a large proportion of pension schemes buying FM services selected a provider that was also their existing investment consultant. The theory of harm considered in this paper may therefore impact a large part of the sector.
72. The CMA survey indicates that, when first buying FM services, some schemes took actions with the potential to support competition and mitigate conflicts, such as seeking third party advice, running tenders or inviting proposals. However, it indicates that a proportion of schemes did not take these steps.
73. We are undertaking further work to assess the characteristics of customers buying FM services, including as part of our demand side workstream. We will incorporate relevant findings into this work in due course.

## **Supply side assessment**

### **Firms' incentives**

74. We would expect IC-FM firms to have a particular focus on services that they view as being the most profitable for their businesses. In this section, we consider evidence on how profitable FM services are for firms relative to IC services and how this is reflected in their remuneration policies.

### *Internal document review*

75. We reviewed a sample of firms' internal documents including strategy documents, and board/committee papers and minutes produced over the last five years.
76. We found evidence indicating that some firms view (or have viewed) FM as being more profitable than pure IC accounts. For example:
- (a) One firm produced a document (2013) that said: 'Our current [FM] margins are exceptional [sic] high and may not be sustainable in the long

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*119 FM clients who knew the number of FM providers they invited to submit proposals and the sample of 116 FM clients who invited proposals and knew how many FM providers submitted them.*

term.’ The same document also noted that ‘fee compression will occur as the market develops.’<sup>40</sup>

(b) The same firm produced a document (2014) that said: ‘This growth [in the FM business] will come from converting existing [firm name] clients to this higher-margin product.’<sup>41</sup>

(c) [REDACTED].

77. By contrast, we also found that another firm had projected that FM would be less profitable than other services, but would become more profitable over time.

(a) The firm produced a 2013 business plan that included a table of ‘business as usual financials’ projecting that that the division that includes advisory work would have higher margins than the division including FM work.<sup>42</sup>

### *Financial information submitted by parties*

78. In general, FM services are significantly more expensive than IC services.<sup>43</sup> This means that, even if net margins were equal in percentage terms across the two services, firms would generally earn greater profits per customer from FM services rather than IC services.

79. While net profit margins do not provide a complete picture of firms’ incentives, they provide a useful starting point.<sup>44</sup> We reviewed the net profit margin figures supplied by six IC-FM firms in relation to their IC and FM activities.

80. [REDACTED].

81. [REDACTED].

82. We intend to set out our financial analysis, including margins, in a published working paper.

### **Staff remuneration policies**

83. We reviewed firms’ staff remuneration policies in order to assess whether these incentivise IC staff to steer existing customers towards FM services. We asked IC-FMs to provide us with details of their remuneration policies and to

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<sup>40</sup> [REDACTED]

<sup>41</sup> [REDACTED]

<sup>42</sup> [REDACTED]

<sup>43</sup> In the client level data submitted to the CMA, the average annual revenues for an IC client were £68,000 and the average annual revenues for an FM client were £227,000.

<sup>44</sup> We plan to consider different revenue and profit metrics as the investigation progresses.

explain how staff are rewarded when existing advisory (i.e. IC) clients decide to purchase FM from that firm.

84. The submissions that we received showed that:
- (a) None of the IC-FM firms have remuneration policies that specifically reward advisory or FM staff for moving existing clients from advisory to FM services.
  - (b) One of the IC-FM firms has a sales incentive plan that directly rewards certain FM sales staff with a monetary bonus when any customer (whether an existing advisory client or not) begins to buy FM for the first time. The bonus is based on a proportion of the expected revenue that will be earned from the FM client. This scheme is not available to advisory staff.
  - (c) A second IC-FM firm said it was planning to setup a sales incentive plan that would directly reward certain FM sales staff through a monetary bonus when a customer buys FM for the first time. This would apply to sales staff only who are independent of the consulting teams.
  - (d) Several IC-FM firms have bonus schemes under which advisory and FM staff may be eligible to receive a share of overall division profit, depending on how well they have performed in the year. Several firms said that advisory staff could therefore receive an indirect monetary benefit were they to play a role in facilitating the sale of FM services, where this increased firm revenue and where the sale was consistent with wider firm policy.
85. Therefore, it does not appear that any IC-FM firms have schemes that directly link the pay of advisory staff to FM sales. However, it does appear that most IC-FM firms have remuneration schemes that could lead to advisory or FM staff receiving a bonus, should they make a contribution to FM sales that lead to increased revenue for the firm.

#### **Summary of emerging findings on firms' incentives**

86. The evidence we have reviewed on internal documents and our analysis of the financial information provided by the parties indicates that IC-FM firms have incentives to seek to sell FM services to their existing advisory clients.

## **Firms' conflict management policies**

### *Firms' written conflict management policies*

87. We asked firms to submit the internal policy documents that they use to manage conflicts of interest in their businesses.
88. All seven IC-FM firms in our sample provided us with written conflict of interest policies. A common feature of these documents was that they set out general principles for staff to follow, such as the importance of being fair, impartial and acting in the interests of clients. For example:
- (a) A Cambridge Associates document (2017) said: 'CA must act solely in the best interests of our clients, not engage in any activities that would conflict with those interests and ensure that our advice is suitable in terms of their investment objectives, experience and financial circumstances.'
  - (b) An R&M document (2017) said: 'the Group must always act in the clients' best interests and put those interests ahead of our own.'
  - (c) An Aon document (2017) said: 'The expectation is that all colleagues must always act in the best interests of Aon's clients.'
  - (d) A WTW document (2013) said: 'To ensure that our clients' interests come first at all times, we must be careful when considering any assignment that may involve, or may appear to involve, a conflict of interest.'
89. Several firms submitted documents that set out recommended conflict management strategies at a relatively general level. These strategies included: avoiding a conflict by not providing a service; putting in place information barriers on either side of a conflict; and disclosing a conflict to clients. For example:
- (a) A Cambridge Associates document said: 'CA will manage such conflict with a view to ensuring fair treatment for its clients. If CA does not consider that such arrangements are sufficient to manage a particular conflict, it will inform the Client of the nature of the conflict so that the Client can decide how to proceed, or refrain from acting.'
  - (b) A Russell Investments document said: 'Where the arrangements under the firm's conflicts of interest policy are not sufficient to manage a particular conflict, the firm shall inform the client of the nature of the conflict in sufficient detail for the client to understand the effect of that conflict on the services.'



- (c) An Aon document (2017) said: ‘The following are examples of high level measures which may be adopted either singly or together to help manage conflicts of interest:
- (i) Information barriers – use of different teams in different locations to ensure that no communication is shared between employees or teams concerned, e.g. when acting for two different parties in a single transaction.
  - (ii) Disclosure – a client must be informed that we have a potential conflict prior to undertaking business with Aon and where any conflict cannot be managed, this must be disclosed to the client.
  - (iii) Record keeping and management information – details of all instances of actual or potential conflicts of interest and the way in which they are managed should be recorded.’
- (a) R&M submitted a document that said: ‘Such actions may include putting in place controls between the opposing sides of the conflict, which may control or prevent the exchange of information, and/or involve the appropriate management of staff activities and segregation of duties. Where such controls would be insufficient to eliminate the potential material risk of damage to clients from specific conflicts, then the [Adviser/Manager] will disclose the general nature and/or source of those conflicts of interest to the Client prior to undertaking the relevant business.’<sup>45</sup>

90. Several firms submitted policy documents that encourage or require staff to notify others in the organisation when potential conflicts are found. For example:

- (a) WTW (2013) has a facility where staff should email the Conflict Resolution team in the event of a potential conflict.
- (b) Mercer requires staff to disclose actual/potential conflicts to line managers (from a 2013 document).

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<sup>45</sup> In 2018, R&M told us that they had updated the last sentence of their agreements as follows: ‘Where such controls would be insufficient to ensure, with reasonable confidence, that the risks of damage to the interests of a client will be prevented, then the [Adviser/Manager] will disclose the general nature and/or source of those conflicts of interest to the Client and the steps taken to mitigate those risks prior to undertaking the relevant business.’

- (c) Cambridge Associates requires that staff must promptly notify the Compliance Officer if an employee violates or becomes aware of a violation of the Code of Ethics (2017), and
  - (d) R&M said that, where staff believe there is a potential or actual conflict which is not being adequately addressed, they are encouraged to raise this with their line manager for consideration and as necessary inclusion in the Conflicts Register (from a 2017 document).
91. Some firms submitted policy documents that specifically identify the sale of FM to an IC client as an example of a situation where conflicts might arise. Most of the firms that did so set out management strategies, for example:
- (a) A WTW document (2014) states that there is a possible conflict of interest when a fiduciary business exists within an investment consulting firm, given that when an investment consultant advises its client on governance arrangements, ‘there is a danger that it could use this role as a way to advocate for a delegated service.’ It also says ‘The conflict can be managed via the use of a third-party firm to advise on the selection process.’
  - (b) A Mercer document (2017) sets out mitigation steps for conflicts related to the sale of FM services. These include following strict protocols to ensure an informed decision by the client, clear disclosures regarding fees and services and offering these FM solutions only if suitable for client needs.
  - (c) An Aon document (2017) highlights the risk that there is an incentive to steer clients towards a particular Aon DC Solution, which may have potentially greater earnings for the business due to additional services. Mitigation steps include ‘The services must be relevant to the client and the basis for a recommendation should be fully documented. Market Assessments, if required, must be carried out ...A robust and transparent pricing model must be put in place to ensure that service costs are consistent. No remuneration for the outcome of any selection processes or for providing a particular Aon DC Solution to a client.’
92. As noted above, some firms indicated in their Issues Statement responses that part of their conflict management strategy is to avoid providing advice in relation to their own FM service. For example, several firms said that they would introduce clients to FM, but would not advise on or recommend their own FM product.
93. Finally, several firms submitted policy documents that specified sanctions that could apply to staff that fail to follow company conflict management policies. These sanctions included disciplinary action and dismissal. For example:

- (a) An Aon document (2017) said that violations of the personal conflicts of interest policy may result in discipline, up to and including termination of employment.
- (b) An R&M document (2017) said that any breach of the Conflicts of Interest Policy will be regarded as a serious matter and will likely result in disciplinary action being taken against the employee by the Group in addition to any action which may be taken in law.

#### *Firms' independent review processes*

94. We also asked parties whether they had independent review processes in place in order to ensure that client moves from IC to FM were in the best interests of the client and that any conflicts are appropriately managed. Based on six responses received:
- (a) Three parties said that they did not have an independent review process in advance of any move;
  - (b) Two parties said that an independent review process was undertaken by compliance staff in advance of a move. One of these had introduced the process during 2017;
  - (c) Two other parties noted that advice or documents supplied to clients were subject to independent peer review by investment consultant staff, and
  - (d) Only one party said that it undertook retrospective client reviews. It said that these are undertaken periodically by IC staff that are independent of the client team to assess compliance with internal policies and procedures and include those instances where a client has moved from IC to FM.

#### *Summary of emerging findings on conflict management policies*

95. Overall, we consider that some of the conflict policies and processes that IC-FM firms have in place have the potential to help manage the risk that IC customers are steered into FM products against their interests.
96. However, we also note that:
- (a) Some of the guidance in these policy documents is high-level and principle-based, meaning that staff may have different views as to what type of conduct complies with policies when it comes to selling or advising on FM;

- (b) As with any company policies, there may in practice be variable levels of compliance with policies within and across firms, and
  - (c) Several firms say that they introduce but do not advise on their own FM products; this may lead to grey areas where customers are not clear whether a firm is providing impartial advice on FM, or is introducing or promoting their own product.
97. This emphasises the importance of examining evidence on how IC-FM firms have conducted themselves in practice in relation to clients that have moved from IC to FM.

### **Conduct of firms around the points at which their existing clients consider buying FM**

#### *Review of documents supplied by firms to their clients*

98. We have reviewed a sample of documents supplied by the four largest IC-FM firms<sup>46</sup> to clients that were initially buying IC services and then subsequently bought FM services from the same firm. At this stage we have reviewed over 100 documents that were supplied by those four firms to 14 clients over the last five years. The sample includes both DB and DC pension schemes.
99. The purpose of this review was to identify some examples of:
- (a) the types of information and advice that firms provide to clients that are relevant to their FM purchase decisions, and
  - (b) how conflicts of interest that may arise are handled in these documents.
100. We recognise that the firms will have interacted with these clients through other channels of communication in addition to the documents that we reviewed. We also recognise that the examples presented in this section may not be representative of all the documents that the four IC-FM firms in question (or indeed other IC-FM firms) supply to clients. We would note also that most of the documents that we have reviewed so far were provided to clients that purchased partial rather than full FM services; we plan to undertake some further document reviews including for clients buying full FM services and for clients of other IC-FM firms.
101. Table 3 summarises some of the types of information and advice provided by the four IC-FM firms that may have a bearing on customer decisions to purchase FM services.

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<sup>46</sup> Based on their most recent full year revenue for IC and FM services combined.

**Table 3. Some types of information and advice provided by IC-FM firms that may have a bearing on customer decisions**

Stage of customer journey towards FM	Types of information or advice	Example document types
<p><b>1. Early consideration of FM:</b> customer is reviewing aspects of its strategy, developing its understanding of FM and deciding whether to explore further</p>	<p>General introductory information on FM</p>	<ul style="list-style-type: none"> <li>• <b>Advisory presentations</b> to trustees or scheme sponsors explaining how FM works and the general advantages and drawbacks. The same documents may highlight current challenges facing the scheme, such as poor performance.</li> </ul>
<p><b>2. Further assessment of FM:</b> customer is assessing whether FM would suit its needs and deciding whether to proceed with FM product selection</p>	<p>Advice or information on how FM solutions fit with client needs</p>	<ul style="list-style-type: none"> <li>• <b>Advisory presentations</b> to trustees or scheme sponsors explaining how FM could work for the scheme in question.</li> <li>• <b>Asset allocation advisory reports</b> that advise on how a proposed change in asset allocation strategy could be implemented, for example through FM and traditional advisory solutions.</li> <li>• <b>Other advisory reports</b> that explore aspects of investment strategy and provide information on implementation options, including FM options.</li> </ul>
<p><b>3. FM product selection decision:</b> customer is assessing specific FM products and making a purchase decision</p>	<p>Advice or information on specific FM products</p>	<ul style="list-style-type: none"> <li>• <b>Marketing presentations or reports</b>, setting out the features of the firm's own FM product.</li> <li>• <b>Manager/product selection advisory reports</b>, that compare an FM product to one or more alternative products or solutions. These are sometimes supplied as an input to a trustee meeting where</li> </ul>

Stage of customer journey towards FM	Types of information or advice	Example document types
		<p>the issue will be discussed and the decision taken.</p> <ul style="list-style-type: none"> <li>• <b>Formal advisory letters</b> regarding the suitability of the firm's FM product for the client.</li> </ul>

102. Based on the documents that we have reviewed to date, the trustee customer journey from early consideration of FM through to final FM purchase decision can take several years, with IC-FM firms providing a range of information and advice during this process.

103. Where firms were providing early-stage advice on FM, in some cases firms' documents mentioned their own FM service, whereas in other cases they only discussed FM in general terms, without mentioning any providers. We did not find any examples in these documents where firms mentioned the FM services of rival FM providers. For example:

(a) An investment strategy report (2013) mentions the firm's own FM solution and does not mention rival FM solutions.

(b) A training report for an Investment Sub-Committee (2014) sets out advantages, disadvantages and likely costs for various implementation models. It discusses FM in general terms without reference to the firm's own FM product.

(c) A report for trustees on investment strategy and governance (2015) discusses FM in general terms without reference to the firm's own FM product or rival FM products.

104. As trustees moved closer to the FM purchase decision, we found that the firms in question generally produced more detailed information on their own FM service. Sometimes this information was provided as part of a wider advisory document, and sometimes it was provided as part of a presentation that appeared to have the main purpose of explaining/promoting the firm's own FM service. For example:

(a) A document on governance and implementation options (2015) includes a case study which mentions the firm's own FM product. The document does not mention rival FM solutions. The document compares several

implementation options using characteristics such as estimated fees, degree of hedging, investment efficiency, and trustee time and expertise required. The document is authored by a senior investment consultant and a senior investment analyst and includes, in small print, a disclaimer at the end of the slide pack stating it is 'for training purposes only' and 'is not intended to provide any advice.'

(b) A presentation on the firm's fiduciary solution (2015) was provided near to the date that the trustees chose to adopt FM. This document appears to have a sales/marketing purpose, in that the title and contents mainly relate to the firm's own FM product. However, the footer on each slide indicates that the presentation was produced by the firm's IC practice rather than its FM practice.

105. Where the firms in question compared their own partial-FM service to alternative options, in each case that we reviewed, these alternative options were variants of the traditional advisory model,<sup>47</sup> in which trustees would retain responsibilities for selecting underlying asset managers. We did not find any examples of firms comparing their own FM services to those of rival FM providers. For example:

(a) A manager selection report for trustees (2015) considers two approaches to implementing an asset allocation strategy. One of these is a fiduciary approach and the second is a 'traditional' advisory approach, with trustees retaining responsibility for monitoring and hiring/firing the underlying managers. The report compares the firm's own fiduciary option with the two managers/funds that are shortlisted for the advisory option.

(b) A strategy review presentation (2014) compares four implementation options. One of these is to delegate to the firm through FM, and three of which would see the firm continue in a 'traditional consulting/investment advice' capacity.

106. It is not straightforward to say how these practices might impact competition. Where IC-FM firms compare their FM services to non-FM products or services, this may provide some useful information for trustees. However, trustees receiving these comparisons may perceive that they have adequately tested the market and may be less likely to also consider the FM services offered by rival FM providers. We would welcome views on this point.

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<sup>47</sup> In the examples that we reviewed, the firm recommended a shortlist of underlying managers that should be used, were the trustees to select an advisory option.

107. Where the firms produced these detailed comparisons, these typically covered past performance and fees of the partial-FM option and of the advisory options.<sup>48</sup> For example:

- (a) A presentation on the firm's fiduciary solution (2015) provides additional detail on cost in that it sets out implementation fees (legal fees and investment consultancy fees) in addition to ongoing fees.
- (b) A strategy review presentation (2014) includes a relatively detailed comparison of past performance and fees.

We are investigating the information that is available to trustees in relation to the fees and quality of investment consultants and fiduciary managers as part of our demand side work.<sup>49</sup>

108. We found several examples of advisory documents that mentioned the firm's own FM product and did not mention conflicts of interest. We found other documents that did mention conflicts of interest. These ranged from general, high-level statements, to more specific statements acknowledging specific conflicts relating to the provision of advice on FM. For example:

- (a) An investment strategy report (2013) that mentions the firm's FM product contains a notice saying that conflicts of interest disclosures can be accessed at the company's website or through the firm's representative. A subsequent investment strategy and funding considerations report (2015) contains a notice saying that in certain circumstances the firm's advice will be limited to the solutions that it offers, and that the firm seeks to manage this conflict through procedures designed to protect the interests of clients.
- (b) A report on investment strategy (2015) mentions the firm's own FM product and does not mention conflicts of interest. A report on governance and implementation options (2015) mentions conflicts of interest in a general sense, but not in relation to advice on fiduciary management. The document includes, in small print, a disclaimer at the end of the slide pack stating it is 'for training purposes only' and 'is not intended to provide any advice.'
- (c) A manager selection report (2015) that compares the firm's fiduciary option to advisory options does not mention conflicts of interest.

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<sup>48</sup> The past performance of the advisory options were established by reference to the underlying managers that would be used.

<sup>49</sup> For example, see our [working paper](#) on fees and quality information.



(d) A formal advisory letter to trustees regarding the suitability of its partial-FM product (2015) notes that: there is a potential conflict in that the firm is advising on a service for which it would receive a fee, that this has been explained and that the firm considers that trustees have adequately considered alternatives.

109. As noted above, we plan to undertake some further document reviews including for clients buying full FM services and for clients of other IC-FM firms. We intend that these further reviews will include some additional clients of the four IC-FM firms referred to above and also some clients of IC-FM firms with smaller combined IC and FM businesses.
110. In the meantime, we are interested in parties' views on the matters identified above in the customer journey towards a potential decision to purchase FM services and whether there are any other matters that we should also take into account.

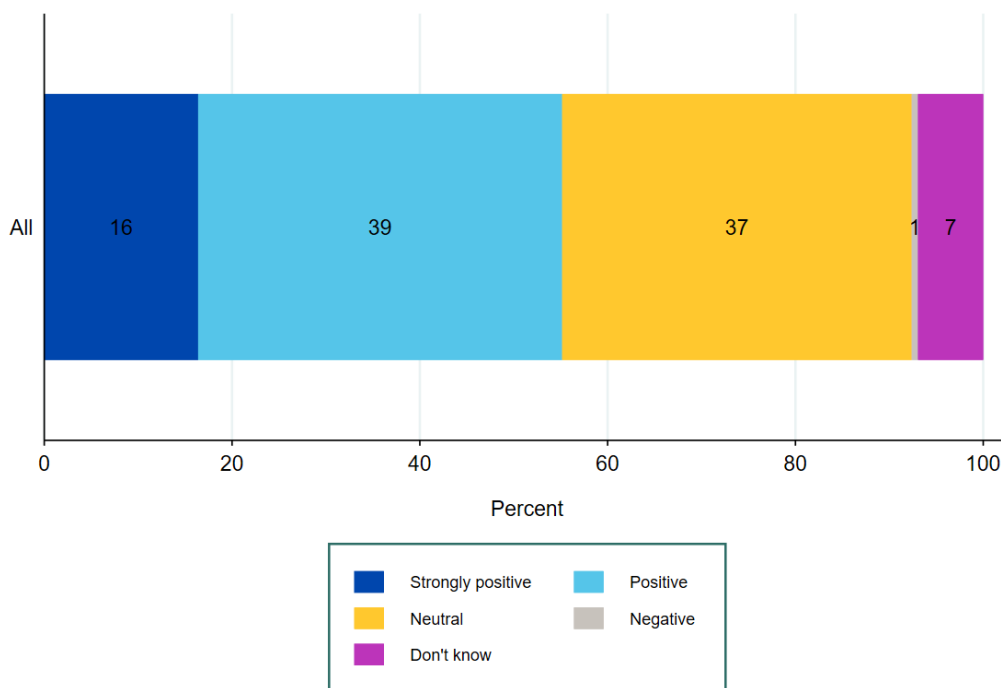
### **CMA trustee survey**

111. The CMA survey asked trustees a series of questions regarding what the incumbent IC said and did in relation to FM.
112. Around a fifth of trustees (19%) said that their IC had suggested that the scheme consider fiduciary management.<sup>50</sup> 37% of trustees currently buying IC services from one of the three largest IC-FM firms said that their IC had suggested that the scheme consider fiduciary management.<sup>51</sup>
113. In discussions about whether fiduciary management was right for the scheme, over half of trustees either said the IC was positive (39%) or strongly positive (16%). 37% said that the IC was neutral and less than 1% said that the IC was negative.

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<sup>50</sup> Source: CMA survey, question P5. 'Has your current investment consultant ever suggested that you consider fiduciary management for your scheme?', question L1 'Thinking back to when you first bought fiduciary management for your scheme, who, if anyone prompted you to consider buying these services? We mean the first time ever that you bought fiduciary management, which was not necessarily from your current provider.', and question L2 'You didn't mention them, so can you please confirm that your investment consultant at the time was NOT amongst those who prompted the board of trustees to first consider buying fiduciary management?'.  
<sup>51</sup> Ibid.

**Figure 3. Attitudes of investment consultants towards FM in discussions**

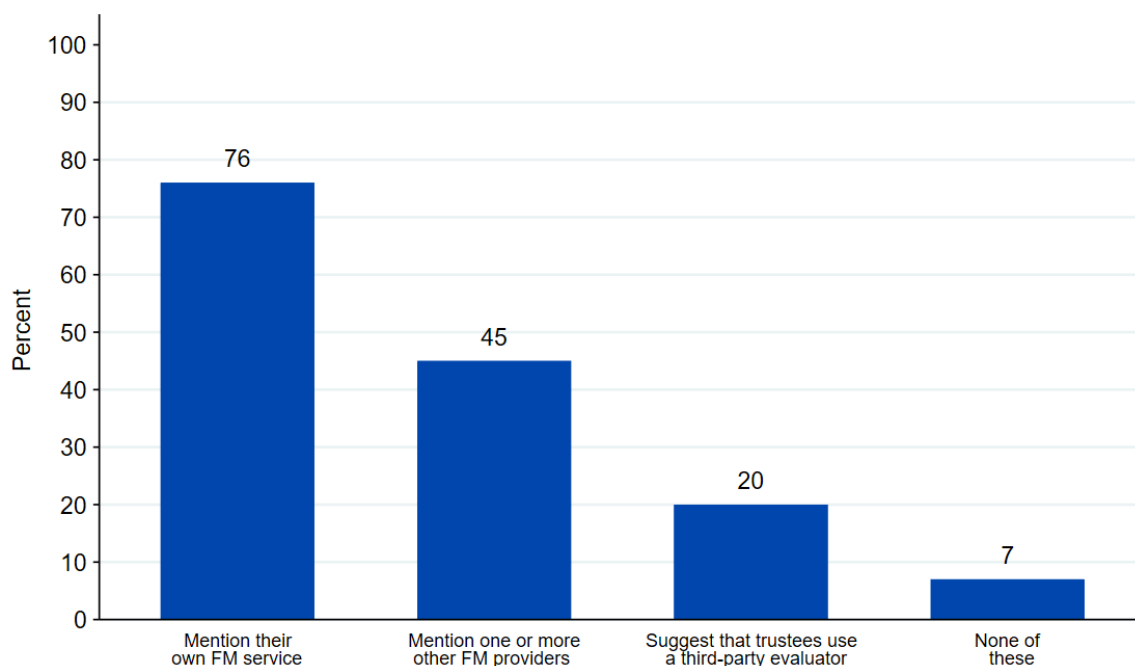


*All schemes where IC provider suggested using FM: All (150)*

Source: CMA survey, question L4 'And in discussions with your investment consultant, at the time about whether fiduciary management was right for your scheme, would you say they were ...?' and P7. 'And in discussions with them about whether fiduciary management was right for your scheme, would you say they were ...'

114. Where the IC had suggested fiduciary management, we asked trustees what else the IC did. The chart below shows that:
- (a) in the majority of cases the IC also mentioned its own FM service (76%);
  - (b) in just under half of cases, the IC also mentioned one or more other FM providers (45%), and
  - (c) in a fifth of cases, the IC suggested that trustees use a third party evaluator (20%).

**Figure 4. Behaviours of investment consultants in discussions about FM**



*All schemes where IC provider suggested using FM: All (150)*

Source: CMA survey, question L3 'Which of the following things, if any, did your investment consultant do at the time you first bought FM?' and question P6 'In addition to suggesting fiduciary management, which of the following things, if any, did they also do?'.

### **Review of firms' internal documents**

115. As part of our review of internal strategy and board/committee documents produced by firms over the last five years, we also looked for evidence on firms' strategies for selling their FM services.
116. These documents indicate that several IC-FMs have actively sought to cross-sell FM services to their existing IC customers. For example:
- (a) A strategy document (2017) contained a series of actions, including: 'Increase penetration of [FM] solutions within existing client base'.<sup>52</sup>
  - (b) A strategy document produced by another firm (2016) said:<sup>53</sup>
    - (i) 'Cross sell [FM and other services] in the acquired client base';

<sup>52</sup> [X]  
<sup>53</sup> [X]

(ii) [in relation to IC] 'Cross selling [FM]'

(c) Another firm produced a document (2017) saying that: 'Within the corporate pension fund segment, we will concentrate our direct sales efforts on a focused list of 40 - 50 accounts where we have already built brand recognition or have existing ties through advisory or implementation services'<sup>54,55</sup>

117. We found statements where firms indicated that they took account of client needs and identified client benefits. For example:

(a) A strategy document (2017) said 'There is an opportunity to grow assets where appropriate for client needs'.<sup>56</sup>

(b) A strategy document produced by another firm (2014) said: '[FM can] bring our best ideas to our clients more quickly and at lower cost than the traditional advisory model'.<sup>57</sup>

118. Some of the statements that we reviewed in internal documents indicated that some firms may have had particularly strong and persistent cross-selling strategies. For example, in one document (2014) a firm indicated that it planned to pursue the cross-selling of FM even though this could damage client relationships:

(a) 'Adopt a [FM]-first approach with more clients and accept the risk of relationship damage and loss'.<sup>58,59</sup>

119. We also found evidence that some IC-FM firms have sought to use their IC staff as a gateway for FM staff to sell FM services. For example, one firm produced a business plan document (2014) that said:<sup>60</sup>

(a) '[FM] Sales leads have regular meetings and 1:1s with our internal consultants;'

(b) 'Our internal consultants are still a barrier to raising [FM] (and [the FM] team accessing the client) however this has improved over the past year. Opportunities are still being missed', and

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<sup>54</sup> [REDACTED]

<sup>55</sup> The firm said that these accounts largely represented sources of new business and that the reference to existing ties was made with regard to a subset of these accounts.

<sup>56</sup> [REDACTED]

<sup>57</sup> [REDACTED]

<sup>58</sup> The firm told us that the 'relationship damage' referred to was that the client would be likely to go out to competitive tender which meant they would be lost as an advisory client.

<sup>59</sup> [REDACTED]

<sup>60</sup> [REDACTED]

- (c) 'A number of initiatives to continue to improve the flow of prospects from internal channels: Revenue generated in [the FM division] flows back to individual client teams in the [IC division] – thus ensuring they do not feel they are cannibalising their own business'.

*Summary of emerging findings on the conduct of firms around the points at which clients consider buying FM information*

120. Based on documents and other evidence reviewed to date, we have seen some examples of IC-FM firms:
- (a) having strong and persistent strategies to sell FM to existing IC clients;
  - (b) mentioning their own FM service to IC clients, but not mentioning other FM providers;
  - (c) producing documents that compare their own FM service to alternative (non-FM) products or services; and
  - (d) producing documents that provide advice on FM and do not mention conflicts of interest, or only mention conflicts of interest in a general sense.
121. We recognise that it is not straightforward to say how the practices above might impact competition. However, depending on the context, these practices could contribute to some customers being steered towards the FM services of their incumbent IC without having fully considered the alternatives. We welcome evidence and views on whether and if so how the practices above impact competition and customers.

## **Outcomes for customers**

122. We are assessing outcomes for customers of IC-FM firms as part of our outcomes workstream. We will incorporate relevant findings into this work in due course.

## **Summary of emerging findings**

123. Overall, it is clear that the demand for FM services has grown strongly in recent years and that a significant proportion of FM customers have bought these services from their existing IC. We have seen some evidence of practices and behaviours on the supply and demand side that could be consistent with some customers being steered towards the FM services of

their incumbent IC, without having applied much competitive pressure on the incumbent firm.

124. We welcome further evidence and views on the theory of harm, evidence and emerging findings set out in this document.

## Potential remedies

125. In our Issues Statement we set out a number of hypothetical potential remedies including some which were directly relevant to this theory of harm. In light of our analysis and the evidence and submissions from parties we have received to date, we have expanded the range of potential remedies that could be used to address aspects of any AEC that may be found in relation to this area.
126. We categorise potential remedies as either:
- (a) Seeking to encourage trustee engagement; or
  - (b) Reducing the risk of conflict by controlling or incentivising firms' behaviours.
127. We discuss each in turn below. We also note that several of these remedies could also potentially address other AECs that we may find, for example regarding trustee engagement.

### *Measures to encourage trustee engagement*

128. The following remedies could promote trustee engagement by encouraging more active consideration of the choice of FM provider, particularly on first appointment.
- (a) **Mandatory tendering on first adoption of FM Services.** In the Issues Statement we framed mandatory tendering as a periodic event. For those schemes which have not adopted FM to date, a more targeted remedy could be the requirement for trustees to hold a formal tender process when first adopting FM. This could be either an open or closed process but would need to adhere to a set of minimum criteria.
  - (b) **Trustee reporting to scheme members or TPR.** To strengthen incentives for trustees to act in members' interests a remedy could require trustees to report on how they have done this. This could be further enhanced through a requirement on trustees to report and demonstrate how they plan to test or have tested the market, potentially aligned with the triennial valuation of the scheme. A range of requirements could be

introduced, such as disclosure of trustee approach to tendering on first appointment and dates of proposed future market testing. This information could similarly be provided to TPR.

(c) **The provision of guidance to trustees on the adoption and selection of an FM provider.** Such an approach could provide trustees with impartial general advice. This could include both:

(i) advice on choosing whether FM (full or partial) is a service which would be appropriate for the scheme; and

(ii) best practice on how to choose a provider, whether to use a third-party evaluator and how to test the market.

129. We note however that, for example, a requirement to tender on initial adoption of FM could address or mitigate the risk of a conflict of interest arising but would not affect schemes where an appointment had previously been made. Additional remedies may therefore be necessary, either on a transitional or ongoing basis to address historic mandates.

(a) **Measures to require mandatory tendering within a fixed period after first appointment.** Where trustees have not tendered for the FM mandate,<sup>61</sup> a requirement for a one-off tender within a fixed period could be introduced. This would ensure there is market testing but would give trustees flexibility to decide how to make their initial appointment. Where a requirement to tender on first appointment is made, such a remedy could be either focused on historic appointments or on new FM mandates.<sup>62</sup>

(b) **Measures to require mandatory switching.** Requiring mandatory switching after a certain period would ensure that any conflict on initial appointment was addressed.<sup>63</sup> However, this could reduce trustee choice by eliminating the incumbent and potentially introduce additional costs or inefficiencies.

(c) **Measures to require periodic mandatory tendering.** Requiring trustees to conduct a periodic tender process would ensure that trustees are required to actively consider other potential providers. However, each subsequent tender would be less relevant in addressing the conflict (and particularly where the FM provider changed).

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<sup>61</sup> The specific framing would be dependent on whether a tender on initial appointment was mandated.

<sup>62</sup> Where no competitive tender was held and an incumbent adviser was appointed.

<sup>63</sup> Again, this might be applicable only where an incumbent advisory firm was appointed to provide FM services without a competitive tender.

*Measures to reduce the risk of conflicts through controlling or incentivising firm behaviours*

130. In addition to the potential measures set out above to encourage trustees to make a more active decision in relation to the purchase of FM we have identified measures that relate directly to the conduct of business by firms. These measures include:

(a) **Segregation of advice and marketing materials.** Keeping advice on the merits of using FM services separate from the firm's own FM service provision reduces the risk of conflating the two.

(i) To further increase the separation of the two questions (choosing whether to use FM and choosing a provider) there could be a minimum period both before and after any decision to adopt FM and the provision of marketing materials.

(ii) This could further be extended to exclude reference to the provision or performance of the firm's FM services when tendering for advisory services (unless the two were being tendered together).

(b) **Measures to reduce firms' incentives to promote their own FM services.** There are a range of approaches which would either prevent or mitigate the incentives to promote an advisor's own FM service to their advisory customers.

(i) **Legal separation of advisory and consultancy practices.** Requiring firms to potentially sell their advisory or FM businesses would directly address the conflicts of interest present in the sector and ensure there are no indirect incentives to recommend FM services to advisory clients. However this would prevent the firms offering integrated services, which some parties have told us is beneficial.

(ii) **Prohibition of cross-selling advisory and FM services.** This approach would also directly address the potential conflict with lower costs for firms. This would however reduce choice for trustees and potentially reduce the ability of firms to offer integrated services.<sup>64</sup>

(iii) **Internal separation and controls.** The requirement to adopt stronger internal controls, such as 'chinese walls' could reduce the incentive for advisory staff to promote the firm's FM products and services.

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<sup>64</sup> Additional safeguards could allow integrated services to be provided if appointed through a competitive tender.



Although this approach could be more proportionate than the preceding two it is likely to be less effective and would not directly encourage trustees to consider outside alternatives.

- (c) **Regulatory disclosure on adoption of FM.** Advisory firms could be required to present a standard regulatory disclosure to trustee boards when first advising on the use of FM services (and particularly where the firm offers FM services) including on the relative costs of the different solutions. This disclosure could be evidenced and reinforced by a requirement that trustees sign a confirmation that they have noted the relevant considerations of moving into FM and also on the risk of appointing an incumbent. This confirmation could either be retained by the firm or sent to the TPR.
- (d) **Regulatory obligations on firms' conduct.** Such remedies could introduce a requirement for firms to act in trustees' and members' interests. This could be through specific requirements on cross-selling.
- (e) **Prohibition of IC-FM firms acting as an evaluator or offering comparative advice.** To ensure that tender processes or other selection exercises are conducted without perceived or actual bias IC/FM firms which are potential suppliers of FM services<sup>65</sup> could be prohibited from being involved in any aspect of management of the process or assessment of offers.

#### *Questions on potential remedies*

- 131. We welcome parties' views on any aspect of the potential remedies set out above, in particular in terms of their potential effectiveness, proportionality and how they could be implemented.
- 132. Where we have identified additional potential remedies since our Issues Statement we have also identified specific design issues that we are seeking views on.

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<sup>65</sup> Or have business relationships with firms providing advisory or FM services, such as through joint ventures.

## Questions on additional potential remedies

### 1) **Mandatory tendering at the point of adoption of FM or within a fixed period after first appointment.**

- a) What could be the minimum scope of an acceptable competitive tender process (for example the number of firms invited to participate)?
- b) How long should an initial FM mandate last before the requirement for an initial tender?
- c) Should such an approach have a requirement for an open tender process?
- d) Should there be a requirement or encouragement to use a third party evaluator?
- e) Should this requirement exist for both partial and full FM mandates?
- f) Should there be specific requirements for any incremental expansion of an FM mandate (such as additional asset classes)?
- g) Should any other requirement be imposed in relation to schemes which have already adopted an FM approach? If so, what? Should this be limited to schemes that did not competitively tender for FM?

### 2) **Segregation of marketing materials from advice**

- a) Are there currently business models where separation of marketing and advice would be problematic?
- b) How could the key differentiators of marketing and advice be defined?
- c) Could marketing and advice be further separated through a time gap between the decision to adopt FM and the provision of marketing materials?

### 3) **Reporting to members**

- a) Would a requirement to report the actions of trustees to members be sufficient to incentivise trustees to more actively consider an appropriate range of options?
- b) What should be in the scope of this report and should there be any enhanced power for members to challenge any decision.

### 4) **Restrictions on selling both advisory and FM services**

- a) Would the benefits to trustees of receiving both advisory and FM services from the same provider outweigh the potential harm?
- b) Could any restriction be limited to situations where advisory and FM services have not been subject to an open tender process (either separately or in combination)?

## Annex A: Overview of the Legal and Regulatory Framework in relation to the relevant conflicts of interest

### Introduction

133. The subject of conflicts of interest is expressly covered by FCA rules and regulations that apply to firms which it regulates. Regulated firms are primarily those which have a FCA permission to carry on one or more regulated activities.<sup>66</sup> The following are key regulated activities that are relevant for present purposes:

- (a) Advising on investments.<sup>67</sup>
- (b) Managing investments.<sup>68</sup>
- (c) Dealing in investments as agent.<sup>69</sup>
- (d) Dealing in investments as principal.<sup>70</sup>
- (e) Arranging (bringing about) deals in investments.<sup>71</sup>
- (f) Establishing etc. a collective investment scheme.<sup>72</sup>
- (g) Agreeing to carry on a regulated activity.<sup>73</sup>

134. The FCA rules which expressly relate to conflicts of interest are contained in the following parts of the FCA Handbook:

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<sup>66</sup> Regulated activities are set out in the [Financial Services and Markets Act 2000 \(Regulated Activities\) Order 2001](#), SI 2001/544, as amended (the [RAO](#)). Regulation also extends to certain other specific categories of firms, but this point is not covered further in this paper as it does not change the present analysis.

<sup>67</sup> In summary, advice given to a person in their capacity as an investor/potential investor (or their agent) on the merits of (among other matters) buying, selling, subscribing for, holding or underwriting designated investments (FCA Glossary and Article 53(1) [RAO](#)). Note, however, that with effect from 3 January 2018, for the bulk of firms which hold a FCA permission other than (or in addition to) 'advising on investments' or 'agreeing to carry on the regulated activity of advising on investments', the regulated activity of 'advising on investments' applies only to the extent that they provide a 'personal recommendation' (that is the effect of Article 53(1A) – (1D) [RAO](#)).

<sup>68</sup> In summary, the exercise of discretion in managing the assets belonging to another person (FCA Glossary and Article 37 [RAO](#)). See also the related regulated activities 'Managing a UCITS' (FCA Glossary and Article 51ZA [RAO](#) and 'Managing an AIF' (FCA Glossary and Article 51ZC [RAO](#)).

<sup>69</sup> In summary, buying, selling, subscribing for or underwriting designated investments as agent (FCA Glossary and Article 21 [RAO](#)).

<sup>70</sup> In summary, buying, selling, subscribing for or underwriting designated investments as principal (FCA Glossary and Article 14 [RAO](#)).

<sup>71</sup> In summary, making arrangements for another person (whether as principal or agent) to buy, sell, subscribe for or underwrite designated investments (FCA Glossary and Article 25(1) [RAO](#)).

<sup>72</sup> In summary, establishing, operating or winding up a collective investment scheme (FCA Glossary and Article 51ZE [RAO](#)).

<sup>73</sup> In summary, the regulated activity of agreeing to carry on a regulated activity (certain exceptions apply) (FCA Glossary and Article 64 [RAO](#)).

- (a) The '[Principles for Businesses sourcebook](#)' (PRIN), which is a general statement of the fundamental obligations of firms under the regulatory system.<sup>74</sup> Principle 8 provides that '[a] firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.'<sup>75</sup>
- (b) The '[Senior Management Arrangements, Systems and Controls sourcebook](#)' (SYSC), which creates a common platform of organisational and system and control requirements for all regulated firms. SYSC 10 sets out various rules and guidance<sup>76</sup> for regulated firms in relation to conflicts of interest.<sup>77</sup> Among other matters, SYSC 10 makes provision for firms to take all appropriate steps to identify and to prevent or manage conflicts of interest that arise, or may arise, in the course of providing a service that is a regulated activity and which may damage the interests of a client.<sup>78</sup>
- (c) The '[Conduct of Business sourcebook](#)' (COBS), which sets out regulated firms' conduct of business obligations. COBS 6 sets out (among other matters) the information to be provided about the firm to its clients such as information about the firm's conflicts of interest policy.<sup>79</sup>

135. Conflicts of interest are also covered by the framework of European Union (EU) legislation on markets in financial instruments (principally, the Markets in Financial Instruments Directive II, referred to generally as MiFID II).<sup>80</sup> In broad terms, MiFID II applies to 'investment firms', which are firms whose regular business is the provision of 'investment services' and/or 'investment activities' on a professional basis.<sup>81</sup> The investment services and activities to which MiFID II applies include:

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<sup>74</sup> [PRIN 1.1.2G](#).

<sup>75</sup> [PRIN 2.1.1R](#).

<sup>76</sup> Note that certain provisions of [SYSC 10](#) apply as rules or guidance depending on the category of the firm in question and the subject matter, for example, identifying conflicts, having a conflicts policy ([SYSC 10.1.2G](#) and [SYSC 1 Annex 1](#)).

<sup>77</sup> [SYSC 10.1.1R](#). The requirements apply only where a service is provided by a firm ([SYSC 10.1.2G](#)).

<sup>78</sup> [SYSC 10.1.3R](#) and [10.1.4R](#). Firms must also maintain a record of the kinds of service or activity which they carry out in which a conflict of interest entailing a material risk of damage to the interests of one or more clients has arisen or may arise ([SYSC 10.1.6R](#)); and maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from adversely affecting the interests of their clients ([SYSC 10.1.7R](#)).

<sup>79</sup> [COBS 6.1.4R](#) (in respect of non-MiFID business) and [COBS 6.1ZA.5 EU](#) (in respect of a firm's MiFID business).

<sup>80</sup> The EU legislation that is contained in directives is incorporated into the FCA Handbook. However, some aspects of MiFID II are set out in EU regulations and are not covered in the FCA Handbook as they are directly applicable in UK law without the need for national implementing measures.

<sup>81</sup> Article 4(1)(1) of [Directive 2014/65/EU](#).

- (a) investment advice (personal recommendations) on MiFID II financial instruments<sup>82</sup> and, in some cases, structured deposits;<sup>83</sup>
  - (b) portfolio management,<sup>84</sup> and
  - (c) the reception and transmission of orders relating to MiFID II financial instruments.<sup>85</sup>
136. MiFID II also covers a range of ‘ancillary services’ which include: investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments.<sup>86</sup>
137. In recognition of the increased potential for conflicts of interest arising from the expanding range of activities undertaken by many investment firms, MiFID II places various duties on firms to identify and prevent or manage those conflicts. MiFID II also recognises the need to protect clients from conflicts arising where staff are incentivised to recommend or sell a particular financial instrument when another product may better meet the client’s needs.<sup>87</sup>
138. More specifically, MiFID II provides for the following in respect of conflicts of interest:
- (a) Oversight of, and accountability for, conflicts of interest by the management body of an investment firm.
  - (b) Taking appropriate steps to identify conflicts of interest and the minimum criteria to be taken into account when identifying such conflicts of interest.
  - (c) Taking steps to prevent or manage conflicts of interest, using disclosure of conflicts to the client as a last resort where the other arrangements.

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<sup>82</sup> The list of such instruments includes: transferable securities; money-market instruments; and units in collective investment undertakings (UCITS) (Article 4(1)(2) and (15) of [Directive 2014/65/EU](#) and Annex 1, Section C). Other instruments include options, futures, swaps and other derivative contracts relating to a wide range of matters.

<sup>83</sup> Investment advice is defined to mean ‘the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments’ (Article 4(1)(4) of [Directive 2014/65/EU](#)). For these purposes, a ‘personal recommendation’ is, in summary: (a) a recommendation that is made to a person in his capacity as an investor or potential investor (or an agent of either), (b) it is presented as suitable for that person or is based on a consideration of the circumstances of that person, (c) it is a recommendation (among other matters) to buy, sell, subscribe for, hold or underwrite a particular financial instrument, and (d) it is not issued exclusively to the public (Article 9 of [Delegated Regulation \(EU\) 2017/565](#)). In relation to structured deposits, see Article 1(4) of [Directive 2014/65/EU](#).

<sup>84</sup> Portfolio management is defined to mean ‘managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments’ (Article 4(1)(8) of [Directive 2014/65/EU](#)).

<sup>85</sup> Article 4(1)(2) of [Directive 2014/65/EU](#) and Annex 1, Section A. Other services and activities include the execution of orders and the underwriting and placing of financial instruments.

<sup>86</sup> Article 4(1)(3) of [Directive 2014/65/EU](#) and Annex 1, Section B.

<sup>87</sup> Article 27(1) of [Delegated Regulation \(EU\) 2017/565](#) provides that ‘[r]emuneration policies and practices shall be designed in such a way so as not to create a conflict of interest or incentive that **may lead relevant persons to favour their own interests or the firm’s interests to the detriment of any client**’ (emphasis added).

made by firms are not sufficient to prevent damage to the interests of clients.

(d) Keeping and regularly updating a record of conflicts.

(e) Having an effective conflicts of interest policy.

139. Further detail on the above provisions is set out at paragraphs [246] onwards below.

### **Coverage of investment consultancy and fiduciary management services**

140. On the basis of submissions made to us and documents we have seen to date, our understanding is that the services of investment consultancy and fiduciary management can fall into any one or more of the following FCA-regulated and MiFID-specific activities:

(a) Investment consultancy services:

(i) FCA-regulated: Advising on investments;<sup>88</sup> Agreeing to carry on a regulated activity.

(ii) MiFID-specific: investment advice (personal recommendations).

(b) Fiduciary management services:

(i) FCA-regulated: Managing investments; Dealing in investments as agent; Dealing in investments as principal; Arranging (bringing about) deals in investments; Establishing etc. a collective investment scheme; Agreeing to carry on a regulated activity.

(ii) MiFID-specific: portfolio management; the reception and transmission of orders.

### **Specific provisions on conflicts of interest**

141. The following paragraphs provide some further detail, in summary form, of key provisions in MiFID II and provisions in the FCA Handbook in respect of conflicts of interest which are relevant to MiFID firms. However, not all firms are subject to MiFID and the FCA has detailed rules which specify whether - and if so - how the conflicts of interest provisions in the FCA Handbook apply

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<sup>88</sup> With effect from 3 January 2018, for the bulk of firms which hold a FCA permission other than (or in addition to) 'advising on investments' or 'agreeing to carry on the regulated activity of advising on investments', the regulated activity of 'advising on investments' applies only to the extent that they provide a 'personal recommendation' (that is the effect of Article 53(1A) – (1D) [RAO](#)).

to non-MiFID firms (i.e. whether they apply as rules, as guidance or are disapplied).<sup>89</sup> Therefore, the conflicts of interest provisions which apply in a particular case will, amongst other things, depend on the specific circumstances of the firm.

### *Oversight and accountability – management body*

142. MiFID II makes provision for various matters in respect of the oversight of, and accountability for, arrangements to prevent conflicts of interest. The following provisions are key:

- (a) Investment firms must ensure that their management body<sup>90</sup> ‘defines, oversees and is accountable for’ the implementation of governance arrangements that ensure various matters, including the segregation of duties in the investment firm and the prevention of conflicts of interest in a manner which promotes market integrity and the interests of clients.<sup>91</sup>
- (b) The governance arrangements must also ensure that the management body defines, approves and oversees various matters, including a remuneration policy of staff involved in the provision of services to clients that aims to encourage ‘responsible business conduct, fair treatment of clients as well as avoiding conflict of interest in the relationships with clients’.<sup>92</sup>
- (c) The management body must also monitor and periodically assess the effectiveness of the investment firm’s governance arrangements and the adequacy of the policies relating to the provision of services to clients and take appropriate steps to address any deficiencies.<sup>93</sup>

### *Taking appropriate steps to identify and to prevent or manage conflicts of interest*

143. An investment firm must take all appropriate steps to identify and to prevent or manage conflicts of interest -

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<sup>89</sup> See SYSC 1 Annex 1.

<sup>90</sup> This is defined to mean ‘the body or bodies of an investment firm ... , which are appointed in accordance with national law, which are empowered to set the entity’s strategy, objectives and overall direction, and which oversee and monitor management decision-making and include persons who effectively direct the business of the entity’ (Article 4(1)(36) of Directive 2014/65/EU).

<sup>91</sup> Article 9(3) of Directive 2014/65/EU and SYSC 4.3A.1R.

<sup>92</sup> Article 9(3) of Directive 2014/65/EU and SYSC 4.3A.1AR.

<sup>93</sup> Article 9(3) of Directive 2014/65/EU and SYSC 4.3A.1R.

(a) between the firm, including, for example, its managers, employees, tied agents and persons directly or indirectly linked by control (the relevant persons) and their clients, as well as

(b) between one client of the firm and another client<sup>94</sup>

144. that arise, or may arise, in the course of providing investment or ancillary services (or combinations of them). The conflicts in question include those caused by the firm's own remuneration and other incentive structures.<sup>95</sup>

145. MiFID II<sup>96</sup> builds on and strengthens the conflicts of interests provisions that were in MiFID I, for example, by expressly referring to (a) the need to *prevent* conflicts and (b) to conflicts being caused by third party inducements or the firm's own remuneration and other incentive structures.

#### *Types of conflicts – minimum criteria*

146. For the purposes of identifying the types of conflict of interest which may damage the interests of a client, investment firms must take into account certain minimum criteria. These include whether as a result of providing the relevant services or investment activities or otherwise, the investment firm, a relevant person, or a person directly or indirectly linked by control to the investment firm:

(a) is likely to make a financial gain, or avoid a financial loss, at the expense of the client;

(b) has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome;

(c) has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;

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<sup>94</sup> Article 23(1) of [Directive 2014/65/EU](#) and [SYSC 10.1.3R](#). In respect of the scenarios (a) and (b) above, Recital 45 to Delegated Regulation (EU) 2017/565 and [SYSC 10.1.5G](#) provide that it is not enough that the firm may gain a benefit if there is not also a possible disadvantage to a client, or that one client to whom the firm owes a duty may make a gain or avoid a loss without there being a concomitant possible loss to another such client.

<sup>95</sup> Article 23(1) of [Directive 2014/65/EU](#) and [SYSC 10.1.3R](#). Article 27(1) of [Delegated Regulation \(EU\) 2017/565](#) provides that remuneration policies must be designed so as not to create a conflict of interest or incentive to the potential detriment of any client.

<sup>96</sup> MiFID II is the EU package supplementing the provisions of the MiFID regime which applied in the UK from November 2007. Changes made by MiFID II were implemented in the UK by amendments to the FCA Handbook which came into effect on 3 January 2018.



- (d) receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monetary or non-monetary benefits or services.<sup>97</sup>

#### *Keeping and regularly updating a record of conflicts*

147. Delegated Regulation (EU) 2017/565 provides that investment firms must keep and regularly update a record of the kinds of investment or ancillary service or investment activity carried out by or on behalf of the firm in which a conflict of interest entailing a risk of damage<sup>98</sup> to client interests has arisen, or in the case of an ongoing service or activity, may arise.<sup>99</sup>
148. It also provides that senior management must receive on a frequent basis, and at least annually, written reports on such situations.<sup>100</sup>

#### *Disclosure of conflicts to the client*

149. Where the arrangements made for preventing conflicts are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm must clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business for the client.<sup>101</sup> The firm must include sufficient detail, taking into account the nature of the client, to enable the client to take an informed decision with respect to the service in the context of which the conflict of interest arises.<sup>102</sup>
150. [Delegated Regulation \(EU\) No 2017/565](#) and the FCA Handbook also provide that the disclosure must: clearly state that the firm's arrangements in respect of conflicts are not sufficient to ensure, with reasonable confidence, that the risk of damage to client interests will be prevented; include specific description of the conflicts of interest that arise; and explain the risks to the client that arise as a result of those conflicts.<sup>103</sup>
151. [Delegated Regulation \(EU\) No 2017/565](#) further provides that disclosure of conflicts should be treated as 'a measure of last resort': over-reliance on

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<sup>97</sup> For these and other minimum criteria, see Article 33 of [Delegated Regulation \(EU\) 2017/565](#).

<sup>98</sup> It is noteworthy that under MiFID II, the EU regime has been tightened: prior to MiFID II, the EU legislation required record keeping in respect of conflicts entailing a 'material' risk of damage to client interests (Article 23 of [Directive 2006/73/EC](#)), whereas under MiFID II there is no longer a requirement of materiality.

<sup>99</sup> Article 35 of [Delegated Regulation \(EU\) 2017/565](#).

<sup>100</sup> Article 35 of [Delegated Regulation \(EU\) 2017/565](#).

<sup>101</sup> Article 23(2) of [Directive 2014/65/EU](#) and [SYSC 10.1.8R\(1\)](#).

<sup>102</sup> Article 23(3) of [Directive 2014/65/EU](#) and [SYSC 10.1.8R\(2\)\(e\)](#). The disclosure must be made in a durable medium.

<sup>103</sup> Article 34(4) of [Delegated Regulation \(EU\) 2017/565](#) and [SYSC 10.1.8R\(2\)](#).

disclosure is not permitted and it is not a substitute for the requirement to maintain and operate effective arrangements to prevent conflicts arising.<sup>104</sup>

### *Effective conflicts of interest policy*

152. Delegated Regulation (EU) 2017/565 provides that investment firms must establish, implement and maintain an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the firm and the nature, scale and complexity of its business.<sup>105</sup> It goes on to make specific, detailed provision in respect of the content of such a policy, for example:
- (a) the policy must identify the circumstances which constitute or may give rise to a conflict of interest entailing a risk of damage to client interests;
  - (b) the policy must specify procedures to be followed and measures to be adopted in order to prevent or manage such conflicts; and
  - (c) the procedures and measures must include at least those matters that are necessary to ensure the requisite degree of independence of the persons engaged in different business activities involving a conflict of interest (such as preventing or controlling the exchange of information between relevant persons, separate supervision of relevant persons, and preventing or limiting any person from exercising inappropriate influence over the way in which a relevant person carries out investment or ancillary services or activities).<sup>106</sup>
153. The Regulation makes additional specific provision for a range of other matters. For example, in respect of investment research,<sup>107</sup> the Regulation provides that investment firms must have in place arrangements designed to ensure that (among other matters) there is a physical separation between the financial analysts involved in producing investment research and other persons whose responsibilities may conflict with the interests of persons to whom the investment research is disseminated, or (if such physical separation is not appropriate to the size and organisation of the firm) the establishment and implementation of appropriate alternative information barriers.<sup>108</sup>

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<sup>104</sup> Article 34(4) and (5) of [Delegated Regulation \(EU\) 2017/565](#). See also [SYSC](#) 10.1.9G and 10.1.9AR.

<sup>105</sup> Article 34(1) of [Delegated Regulation \(EU\) 2017/565](#).

<sup>106</sup> Article 34(2) and (3) of [Delegated Regulation \(EU\) 2017/565](#).

<sup>107</sup> Article 36(1) of [Delegated Regulation \(EU\) 2017/565](#) defines investment research. The key components of the definition are that investment research is 'research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or the issuers of financial instruments' and which is described as investment research or is presented as an objective or independent explanation of the matters in the recommendation.

<sup>108</sup> Article 37(2)(c) of [Delegated Regulation \(EU\) 2017/565](#).

154. The Regulation also provides that investment firms must assess and periodically review, on an at least annual basis, their conflicts policy and take all appropriate measures to address any deficiencies.<sup>109</sup>
155. FCA guidance provides further that in drawing up a conflicts of interest policy, a firm should pay special attention to the activities of investment research and advice, proprietary trading and portfolio management among other matters. It adds that in particular, such special attention is appropriate where the firm or a person directly or indirectly linked by control to the firm performs a combination of two or more of those activities.<sup>110</sup>
156. Delegated Regulation (EU) 2017/565 provides that investment firms must provide clients or potential clients with (a) a description (which may be in summary form) of their conflicts of interest policy and (b) at the request of the client, further details of their policy in a durable medium or by means of a website. The information in (a) and (b) must be provided in 'good time' before investment services or ancillary services are provided to clients.<sup>111</sup>

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<sup>109</sup> Article 34(5) of [Delegated Regulation \(EU\) 2017/565](#).

<sup>110</sup> SYSC 10.1.12G reflecting recital (47) of [Delegated Regulation \(EU\) 2017/565](#).

<sup>111</sup> Article 47(1)(h) and (i) of [Delegated Regulation \(EU\) 2017/565](#).